COMPARISON OF
PRESENT LAW, A DISCUSSION PROPOSAL AND POSSIBLE CLARIFICATIONS OFFERED BY REPRESENTATIVES STARK AND MOORE,
relating to the tax treatment of life insurance companies and their products

Prepared by the staff of
The Joint Committee on Taxation
for use by
the Subcommittee on Select Revenue Measures,
Committee on Ways and Means

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INTRODUCTION

This document, prepared for use by the Subcommittee on Select Revenue Measures of the Committee on Ways and Means at its August 2, 1983, meeting, provides a comparative description of present law and a discussion proposal relating to the tax treatment of life insurance companies and their products advanced by Subcommittee Chairman Stark and Representative Moore. Also presented are clarifications of, and modifications to, the discussion proposal which will be suggested by Representatives Stark and Moore.

Item	Present Law	Stark-Moore Discussion Proposal	Clarifications and Proposed Modifications
1. Structure of the Corporate Level Tax	Life insurance companies are taxed using a 3-phase approach. Phase I taxes investment income currently. Phase II taxes gain from operations--combining both investment income and underwriting gain or loss; if underwriting gain, only one-half is taxed currently. Phase III taxes the untaxed underwriting gain if and when distributed to shareholders.	Life insurance companies would be taxed using a single phase approach without distinguishing between investment and underwriting income and expenses. The generally applicable corporate tax rules would apply but special rules would govern-- (1) the deduction for reserves (item 2, below), (2) the deductibility of policyholder dividends (item 3, below), (3) the treatment of small companies (item 5, below), and (4) the aggregate tax burden on the industry generally (item 6, below). Effective date.--Taxable years beginning after December 31, 1983. Transition rule.--No express rule is provided for the treatment of amounts potentially subject to the phase III tax.	There are 3 major areas of transition: (1) tax treatment of amounts in the Phase III account; (2) 818(c) and reserve runoff because of new reserve system; and (3) high surplus mutuals that may be at a disadvantage under the ownership differential. During August, the staff will be studying these problems and will make recommendations for subcommittee consideration in September.

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2. Policyholder Reserves			
(a) In general	(a) In general.--Taxable income is computed by allowing, in effect, deductions for increases in reserves required under State law. Special rules apply to: (1) adjust reserves for purposes of the tax on investment income (the Menge formula), (2) allow a revaluation of preliminary term reserves to net level reserves (section 818(c)), and (3) provide additional contingency reserves for: (i) nonparticipating policies and (ii) accident and health, and group life contracts.	(a) In general.--Companies would be allowed a deduction for increases in the prior year-end reserves to the higher of (1) the actual net surrender (cash) values or (2) the minimum reserves required under State law.	
(1) cash surrender values		(1) the actual net surrender (cash) values would be computed by reference to the provisions in the contract guaranteeing cash values, reduced by any penalties or charges which would be imposed upon surrender.	

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(2) minimum State law reserve		(2) the minimum reserve required under State law would be computed by using (i) the least conservative reserve method, (ii) the highest assumed interest rate, and (iii) the most recent mortality table--permitted either as the prevailing view of the States or under the law of the State of issue.	Clarify that, currently, the Commissioner's Reserve Valuation Method (CRVM) is the least conservative reserve method and is generally used to define the minimum standard reserve under State law.
(b) Annuity contracts	(b) Annuity contracts	(b) Annuity contracts.--Before the annuity starting date, the increase in reserve deduction would be allowed only for the increase in net cash surrender value; after the annuity starting date, the general reserve rule would apply.	Staff will continue to study and consider how various miscellaneous insurance reserves (e.g., disability, substandard, waiver of premium, etc.) should be treated, and make recommendations consistent with the policy of the general rule. Likewise, staff will continue to study reserve computation generally (and specifically annuity reserves) with respect to interest guaranteed beyond the taxable year in excess of the assumed rate.

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(c) Accident & health insurance contracts	(c) Accident & health insurance contracts.--Gross premiums are earned pro rata over the life of the contract; unpaid losses are estimated and reserved for on a nondiscounted basis.	(c) Accident & health insurance contracts.--Present-law tax treatment would be retained for unearned premiums and unpaid losses for A&H contracts, Effective date.--Taxable years beginning after December 31, 1983. Transition rule.--Reserves would be recomputed under the new rules as of the close of 1983. Any income or loss arising from the recomputation would be taken into account ratably over 10 years.	
3. Limitation on Deduction for Policyholder Dividends Paid by Mutual Companies ("Ownership Differential") (a) In general	(a) In general.--In computing taxable income, companies are allowed deductions for policyholder dividends and for nonparticipating contracts and A&H and group life contracts, subject to limitations. (1) Under the permanent provisions of the 1959 Act, policyholder dividends (and the special deductions) cannot reduce taxable income below an amount equal to taxable investment income less a statutory amount of $250,000 (Phase I). (2) Under the temporary provisions applicable to 1982 and	(a) In general.--No limitation would be placed on the deduction of policyholder dividends or similar amounts by stock life insurance companies. No special deductions for nonparticipating, A&H and group life contracts. Policyholder dividends paid by mutual companies would not be deductible to the extent they would reduce company taxable income below the amount treated as a pre-tax return on equity to the policyholders in their capacity as shareholders or owners of the mutual company. (Cont.)	(a) In general.-- (1) Adjustments for differences between annual statment and tax accounting--Staff will recommend appropriate adjustments for the pre-tax return on equity to reflect differences, if any, between the annual statement and the company's tax accounting for: ACRS, nonaccrual of market discount, capital gains, and the company's share of tax-exempt income. (Cont.)

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	1983, the 1959 Act rule applies using a statutory amount of $1,000,000, targeted to smaller companies, or any company may elect a limitation of the statutory amount, plus 100 percent of dividends on pension business, plus 77-1/2 percent of nonpension policyholder dividends for mutual companies (85 percent for stocks).	Policyholder dividends would be defined broadly to include excess interest and premium adjustments.	(2) Special rules--To avoid hardships and to account for unusual financial circumstances, both a maximum and a minimum dividend disallowance percentage would be prescribed (staff to make recommendations). (3) Transition rules--Transition rules to avoid hardships for high surplus companies would be considered in September.
(b) Owner's equity	(b) Owner's equity.--Under the 1959 Act, assets held for policyholders in their capacity as owners of the company are not identified in any way. The Act does, however, distinguish between investment assets held with respect to liabilities to policyholders and other investment assets. Investment income earned on assets not held for liabilities to policyholders is taxed at the company level through the limitation in policyholder dividends.	(b) Owner's equity.--Ownership equity of a mutual would be measured and would equal the excess of assets over liabilities as shown for State regulatory purposes, with the following adjustments: (1) nonadmitted financial assets (e.g. not agent's account) would be included; (2) policy reserve liabilities would be computed under the Federal tax rules; (3) any reserve liability for securities valuation would be eliminated (with an adjustment for capital gains taxes); and (4) any reserve liability for policyholder dividends not apportioned and apportioned dividends not payable at the end of the year would be added to surplus.	(b) Owner's equity.--The equity base would be the same as proposed, except that, rather than including the policyholder dividend reserves, the surplus would include 50 percent of policyholder dividends to be paid out (whether or not guaranteed, and adjusted for lapses) in the following year.

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(c) Rate of return		(c) Rate of return.--Mutual companies would be treated as earning (for 1982) a 23 percent pre-tax rate of return on their ownership equity. This rate of return would be adjusted annually to reflect changes in the three year moving average of (1) the rate of return earned on a comparable equity base by stock life insurance companies, (2) the rate of return earned by the top 400 industrial companies, and (3) the rate on 1-year Treasury bills (grossed up by the corporate tax rate). Effective date.--Taxable years beginning after December 31, 1983.	(c) Rate of return.--The rate of return imputed for mutual companies should (as nearly as possible) be the rate earned by comparably situated stock companies. The initial rate could be adjusted to arrive at an appropriate segment balance, under which the mutuals will pay between 50 and 60 percent and the stocks will pay between 50 and 40 percent, of the industry tax burden. For subsequent years, the initial rate would be adjusted according to a moving average of the comparable stock rate for the previous 3 years (companies may use the rate of return imputed for the previous tax year for purposes of making estimated tax payments for the taxable year).
4. Stock Subsidiaries of Mutual Companies	Present law does not directly distinguish between stock subsidiaries of stock and mutual life insurance companies.	Stock subsidiaries that are at least 80 percent owned by mutual companies would be treated as mutual companies. If the mutual parent and stock subsidiary file separate returns, the limitation on the deduction for policyholder dividends (the ownership differential) would be applied to each company on a separate basis. (Cont.)	

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		If a consolidated return is filed, the limitation on the deduction of policyholder dividends would be applied on an aggregate basis and, in effect, allocated in proportion to policyholder dividends. Effective date.--Taxable years beginning after December 31, 1983.	
5. Treatment of Small Companies	There is a small company deduction of $25,000 that is available to all companies. Also, although not limited to small companies, the deferral of tax on one-half of underwriting income, the revaluation of reserves under section 818(c), and the special deductions for nonparticipating and group life and A&H contracts significantly reduce the tax burden of many small companies. Under the temporary provisions applicable for 1982 and 1983, the statutory amount of $1 million for policyholder dividends and special deductions phases out as policyholder dividends and special deductions increase from $4 million to $8 million.	Small companies (those with less than $500 million in assets) would be permitted a deduction equal to 60 percent of the first $1 million of otherwise taxable income. This percentage figure would be reduced to zero as taxable income increases from $1 million to $4 million. Thus, the maximum benefit that could be enjoyed by a small company would be $600,000, and a company with $4 million or more in taxable income would not be entitled to any small company deduction. Eligibility for the deduction would be determined on the basis of affiliated groups. Effective date.--Taxable years beginning after December 31, 1983.	

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6. Taxable Income Adjustment.		All life companies would be allowed a deduction in an amount approximately equal to 25 percent of their taxable income. In the case of an affiliated group, the deduction would be computed by treating all life insurance members as one corporation. The 25 percent deduction would apply after the deduction for policyholder dividends and small companies. Effective date.--Taxable years beginning after December 31, 1983.	Under the Stark-Moore proposal, this is an adjustment mechanism to arrive at a level of revenue deemed appropriate for the industry. As changes are made within the proposed basic structure, the amount of this adjustment may have to change (up or down).
7. Tax-exempt Income	Annual additions of interest to policyholders' reserves treated as funded proportionately out of taxable and tax-exempt income.	Present law rules would be retained. However, the policyholders' share would include all amount credited or paid to policyholders rather than only amounts guaranteed under the policy. Effective date.--Taxable years beginning after December 31, 1983.	
8. Reinsurance	Present law prevents the avoidance of Federal income tax through reinsurance transactions by (1) denying a deduction for interest on reinsurance-related debt, and (2) permitting Treasury to reallocate income	Same as present law.	

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	and deductions in coinsurance transactions between related parties, and (3) treating policyholder dividends as paid by the primary insurer rather than the reinsurers.	Effective date.--Taxable years beginning after December 31, 1983.	
9. Foreign Tax Credit	Present law distinguishes between foreign and U.S. source income on a phase-by-phase basis. Thus, for example, a company taxed in Phase I may claim a foreign tax credit only if it has foreign source taxable investment income.	In computing the foreign tax credit, the limitation would apply on the basis of the ratio of foreign source to worldwide income (same rule as other taxpayers). No distinction between types of income would be made. Effective date.--Taxable years beginning after December 31, 1983.	
10. Definition of Life Insurance Companies	To qualify as a life insurance company, a company must hold more than 50 percent of its reserves as life insurance reserves. It is unclear how pension funds without permanent life annuity purchase rate guarantees should be treated. Under the temporary provisions for 1982 and 1983, no company is allowed to change its life company status because of its treatment of such pension funds.	Reserves on pension funds without permanent life annuity purchase rate guarantees would not be treated as insurance reserves for purposes of the qualification test. Effective date.--Taxable years beginning after December 31, 1983.	

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11. Definition of Life Insurance (a) In general	(a) In general.--There is no statutory definition of "insurance" or "life insurance." Death proceeds paid under a life insurance contract to a beneficiary are exempt from income tax. Income earned on the cash surrender value of a contract is not taxed currently to the policyholder, and is taxed upon termination of the contract prior to death to the extent the cash surrender value exceeds the policyholders' investment in the contract (the aggregate premiums paid). Temporary guidelines For 1983 and 1984, death proceeds from flexible premium policies (e.g. universal life) are treated as life insurance if either of two tests are met. Alternative 1 (a) Premiums paid for the benefit cannot exceed the net single premium (at 6 percent) or the sum of the net level premiums (at 4 percent), assuming the policy matures no earlier than 20 years or age 95, if earlier, and (b) the death benefit must be at least 140 percent of cash value at age 40, phasing down each year to 105 percent (corridor limitation). (Cont.)	(a) In general.--There would be a statutory definition of life insurance for tax purposes. Using the pattern of the temporary guidelines, contracts would qualify as life insurance contracts if they meet either of two tests: Alternative 1 (a) A premium limitation based on a level death benefit, level premium, 10-pay life contract maturing no earlier than at age 95, and (b) a death benefit at least equal to 250 percent of cash value at age 40, phasing down to 110 percent. (Cont.)	The 10-pay limitation should apply to newly issued contracts; thus, there would be a "carryover" payment pattern when one contract is exchanged for another, or when a contract lapses and is converted to a paid-up contract. Also, provision would be made to grade the 110 percent corridor to 100 percent, to allow the contract to mature.

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	Alternative 2 The cash value cannot exceed the net single premium (at 4 percent) for the amount payable at death, assuming the policy matures no earlier than 20 years or age 95, if earlier.	Alternative 2 The cash value could not exceed the cash value of a 10-pay level benefit life contract maturing at age 95 (with an exception for paid-up additions).	
(b) Consequences of failure	(b) Consequences of failure.--Under an IRS ruling, contracts that fail to meet such guidelines would be treated as a combination of term life insurance and an annuity.	(b) Consequences of failure.--Present-law treatment of contracts that meet the definition; contracts that fail would be treated as a combination of term life insurance and a currently taxable deposit fund. Effective date.--Taxable years beginning after December 31, 1983 (December 31, 1984 for certain debit insurance).	
12. Annuity Contracts			
(a) In general	(a) In general.--After the annuity starting date (the payout phase) each payment is treated as part a payment of income out of the contract and part a return of capital (the policyholder's investment in the contract). Distributions prior to the annuity starting date are treated as being made first out of income and then as out of the policyholder's investment in the contract.	(a) In general.--Present law would be retained with respect to the taxation of income from an annuity contract.	

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(b) Penalty on premature distributions	(b) Penalty on premature distrubtions.--Premature distributions from annuity contracts are subject to a penalty tax equal to 5 percent of the amount includible in income.	(b) Penalty on premature distributions.--Same as present law.	
(c) Definition of premature distributions	(c) Definition of premature distributions.--A distribution (including a loan or partial surrender) is treated as premature if made before the annuitant reaches age 59-1/2 and if the income portion of the distribution is attributable to an investment made within 10 years of the distribution. Exceptions are provided for (1) distributions at death (2) distributions on account of disability (3) distributions under an annuity for life or at least 5 years (4) distributions under a qualified pension plan, and (5) distributions allocable to pre-August 14, 1982, investments.	(c) Definition of premature distributions.--The 10-year rule of present law would be eliminated. To conform with the IRA account rules, the entire interest in the deferred annuity would have to be distributed not later than the close of the taxable year in which the policyholder reaches age 70-1/2 or over his life or life expectancy. Exception for annuitization would be modified to require payment over life or at least 10 years. Effective date.--Date of enactment.	

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13. Policyholder Loans	No deduction is allowed for-- (i) interest paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance endowment or annuity contract (other than a single premium contract on a contract treated as a single premium contract) pursuant to a plan which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such a contract. (ii) interest paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment or annuity contract, and (iii) premiums paid on any policy covering the life of any officer, employee or financially interested person, when the taxpayer is a beneficiary. Exceptions are provided to the rule disallowing amounts paid or accrued on indebtedness incurred or continued as part of a plan if-- (i) no part of four of the first seven annual premiums is paid by means of indebtedness,	Present law would continue to apply except that no deduction would be allowed for interest paid on any loan on a life insurance policy to the extent that the aggregate amount of such loans exceeds $50,000 for any person. Effective date - Immediately. Transition rule - The new rule would apply to all outstanding policies, but only with respect to future loans.	. . . Clarify that "immediately" means August 2, 1983. During August, the staff will consider input from industry and agent associations on different ways to deal with tax abuse problems in this area.

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	(ii) the total of the amounts paid or accrued during the taxable year and for which no deduction would be available do not exceed $100, (iii) the indebtedness was incurred because of an unforeseen substantial loss of income or increase in financial obligations, or (iv) the indebtedness was incurred in connection with the taxpayer's trade or business.		
14. Policyholders Investment in a Contract	On the withdrawal of cash from or surrender of a life insurance policy, a taxpayer has income to the extent of the excess, if any, of the amount received over aggregate premiums paid (less return premiums).	For purposes of computing the taxpayer's income from a life insurance contract, aggregate premiums paid would be reduced by the cost of the term insurance protection already provided. The cost of such term insurance would be computed according to the lower of a standard table specified in the statute , or the actual mortality cost stated in the contract (if any). Effective date - Taxable years beginning after December 31, 1983. Transition rule - The provision would apply to all new contracts purchased after the effective date.	

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15. Group-Term Insurance			
(a) In general	(a) In general.--Under present law, an employee can exclude from income the cost of $50,000 of group-term life insurance under a policy (or policies) carried by the taxpayer's employer (or employers). Retired employees do not have to include the cost of group-term insurance at all. Cost of group-term life insurance is determined on the basis of uniform cost table prescribed by regulations.	(a) In general.--Retired employees would be subject to the $50,000 cap on exclusion from income of group-term insurance.	
(b) Nondiscrimination requirements	(b) Nondiscrimination requirements.--The exclusion is not available to key employees covered under discriminatory group-term life insurance plans.	(b) Nondiscrimination requirements.--The nondiscrimination rules will be extended to retired employees. Employees or retired employees under discriminatory plans would not be able to use the uniform cost table.	